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David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW.
Washington, DC 20581

Re: RIN No. 3038-AD99 - Advanced Notice of Proposed Rulemaking — Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (75 Fed. Reg. 75162)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. (“ISDA”) is writing in response to the Advanced Notice of Proposed Rulemaking regarding the Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (the “ANPR”) issued by the Commodity Futures Trading Commission (the “Commission”), seeking comment on possible models for implementing certain provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world’s largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Its members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

ISDA respectfully submits the following responses regarding the ANPR. These responses focus on the Commission’s requests for estimates of industry-wide costs that would be required to implement the various models described in the ANPR. This letter first describes different types of costs implicated by the various models and a suggested methodology for estimating those costs, and then applies that methodology to the individual models to provide industry-wide cost estimates

for each model. It concludes with some observations relating to offering customers the option to choose between different models.

As a general matter, ISDA notes that the estimates provided below have been produced on an expedited basis, and could be substantially improved with further study, including (a) obtaining data (i) from market participants, derivatives clearing organizations (“DCOs”), futures commission merchants (“FCMs”) and other experts as more data on cleared swaps becomes available and (ii) for other types of swaps beyond just interest rates which were the only swaps included in the estimates below and (b) expanding the analysis beyond the “hard dollar” costs to investigate potential systemic costs if moral hazard is introduced by the new models proposed by the Commission. We therefore suggest that the description of the types of cost implied by each of the models described below and the identification of methodologies for measuring those costs are as important as the final estimates produced.

I. Types of Cost

The ANPR requests feedback on the incremental cost that would be incurred in adopting each of three possible models for regulation of the treatment of customers’ collateral posted in respect of cleared swaps, compared with the Baseline Model. The Baseline Model would be based on the regulations that currently apply to collateral posted for futures contracts, and would provide that the money, securities and other property collateralizing the obligations arising out of the cleared swaps positions of all cleared swaps customers of a FCM that is a member of a DCO are held at the DCO on an omnibus basis. The DCO would have recourse to all such collateral (including any collateral representing the value of collateral posted by that FCM’s non-defaulting customers) in the event of any failure of the FCM member to meet a margin call with respect to the FCM’s cleared swaps customer account at that DCO.

The three other models are (1) Full Physical Segregation (the “Individual Segregation Model”), (2) Legal Segregation With Commingling (the “LSOC Model”) and (3) Moving Customers to the Back of the Waterfall (the “Waterfall Model”). We will refer to these models collectively as the “New Models”.

- Under the Individual Segregation Model, each customer’s cleared swaps account, and all property collateralizing that account, is kept separately for and on behalf of that cleared swaps customer, at the FCM, at the DCO, and at each depository. As a result, if the FCM defaults, collateral posted by the defaulting FCM’s non-defaulting customers would not be available to the DCO as a DCO default resource.
- Under the LSOC Model, the collateral of all cleared swaps customers of a FCM member of a DCO is kept on an omnibus basis, but is attributed to each customer based on the collateral requirements, as set by the clearinghouse, attributable to each customer’s swaps. If the FCM defaults, the DCO must treat each customer’s swaps positions, and related margin (based on the positions reported as of the day previous to the default) individually. In particular, the DCO may not use the collateral attributable to the defaulting FCM’s non-defaulting customers as a DCO default resource.

- Under the Waterfall Model, as under the LSOC Model, the collateral of all cleared swaps customers of an FCM member of a DCO is kept on an omnibus basis. Unlike the LSOC Model and the Individual Segregation Model, if the FCM defaults, the DCO may use the remaining collateral attributable to each of the defaulting FCM's customers (including that FCM's non-defaulting customers) as a DCO default resource, but only if the DCO has first applied both (a) the DCO's contribution to its default resources from its own capital and (b) the guarantee fund contributions of all members of the DCO. It is not clear from the ANPR whether "the guarantee fund contributions of all members of the DCO" would include only the funded portion of such guarantee fund contributions, or also any unfunded portion, i.e. further contributions that the DCO's clearing members are liable to make to the guarantee fund pursuant to an assessment authority of the DCO. It has not been necessary for purposes of the cost estimates below to make any assumption on this question, but this point should be clarified to allow end users, clearing members and DCOs to assess the impact of the Waterfall Model on the risk each end user and clearing member bears to the risk of a default by a FCM's customer. If unfunded assessments are required to be completed, clarity should be provided on how multiple sequential customer defaults would be treated.

There are three main types of additional cost that would be implicated in moving from the Baseline Model to one of the three New Models:

- Operational and compliance costs;
- Collateral requirements (increased IM or guarantee fund contributions); and
- Any systemic costs that may be implied by a New Model (including any potential moral hazard). Such potential costs are not addressed in this letter and would be very hard to quantify, therefore requiring further detailed study.

Operational and Compliance Costs

Operational costs will increase to the extent that more operational activity is required to comply with a model's requirements. Operational activity includes establishing and maintaining cash and securities accounts, making transfers to and from cash accounts (including messaging and wire transfer costs) and securities accounts (including receive and deliver fees), performing reconciliations, regulatory reporting, calculating funding requirements for cash and securities and on-boarding and client service activities. These costs are incurred in different ways. Some are likely to be up-front fixed costs, such as costs involved in opening new accounts and internal and external development of technologies to support the new systems, including vendors' ability to make changes to the industry operating systems in a timely manner to support any required implementation of the revised customer protection rules. Others are ongoing costs that may vary with the number of customers clearing through the FCM, such as account maintenance, cash and securities transfer fees, reconciliations, regulatory reporting, calculation of funding requirements, on-boarding of clients and client service, as well as the personnel costs associated with supporting these activities.

It is important to note that, for these purposes, the “customer” of the FCM is the individual legal entity that is the counterparty to swap transactions cleared through the FCM. In particular, in the case of an asset manager that acts on behalf of multiple underlying funds, each individual underlying fund is a customer which will require the set-up and maintenance of increased operational capabilities.

Compliance costs will also increase to the extent requirements applicable to FCM’s become more stringent or complex. Compliance costs are principally ongoing costs incurred in hiring additional staff to oversee and ensure compliance by the FCM with the new requirements.

One aspect of the Waterfall Model that was unclear was whether FCMs would have to report to the DCO, on a daily basis, the portfolio of rights and obligations attributable to each cleared swaps customer and perform necessary related reconciliations. The description of the Waterfall Model states that it is similar to the LSOC Model with two modifications, neither of which relates to the information that would be provided by FCMs obligation in this daily report. Whether this information will be required to be reported under the Waterfall Model may depend upon whether the intent is that the collateral of the defaulting customer should be immediately available as a DCO default resource, with only the collateral of non-defaulting customers being moved to the back of the waterfall. As these reporting and related compliance activities constitute the main additional source of operational and compliance cost for the LSOC Model over the Baseline Model, ISDA believes that clarification of whether these activities are required would result in more accurate cost estimates for the Waterfall Model.

Collateral Requirements

As noted above, under the Individual Segregation Model and the LSOC Model, the collateral of a defaulted FCM’s non-defaulting customers will not be available to the DCO as a DCO default resource. Under the Waterfall Model, the collateral of a defaulted FCM’s non-defaulting customers will only be available to the DCO after the DCO has first applied its own capital and the guarantee fund contributions of its clearing members, which would take some period of time. This stands in contrast to the Baseline Model, in which the collateral of a defaulted FCM’s non-defaulting customers will immediately be available to the DCO as a DCO default resource. This has different implications for the different New Models.

Under the Individual Segregation Model and the LSOC Model, the DCO’s default resources will be diminished compared to the Baseline Model. In order for the DCO to maintain its default resources at levels that are risk-appropriate and reflect applicable regulatory requirements, the DCO will require additional IM and/or additional guarantee fund contributions from the FCM (which costs would likely be passed onto its customers).

Under the Waterfall Model, the total default resources available to the DCO will be the same, but a proportion of those resources (the collateral held in a defaulting FCM’s customer account) will only be available to the DCO after a delay. The DCO, acting prudently, would need to take account of that delay in determining how much IM customers would need to post, because during that delay, the value of the defaulted FCM’s swaps positions and the value of the collateral posted by the customers could change, exposing the DCO to risk of further loss. For cleared OTC derivatives today, IM is typically calculated by DCOs to cover potential price movements during a five day

period to allow the DCO to run through its default procedures (the time necessary will likely vary depending on the applicable asset class). Under the Waterfall Model, the DCO would not be able to access that IM until it had completed its default procedures on the guarantee fund. The amount of additional risk implied by this waiting period may depend on the risk reflected in the customers' portfolio. If the customers' transactions are directional and the asset class is relatively liquid, then the DCO may anticipate being able to hedge the risk in the customers' portfolio during the period in which the default procedures are run in respect of the DCO's guarantee fund. If the portfolio is not directional but is exposed to other risks such as volatility, or if the asset class is less liquid, then the DCO might not be able to hedge the risk in that portfolio during the period in which those default procedures are completed. In this latter case, assuming that the DCO would need an additional time to run through a more complex set of default procedures to incorporate the Waterfall Model, the number of days' risk to be covered by customers' IM would increase. This increased risk would require an increase in IM provided by customers and/or the guarantee fund when compared to the Baseline Model.

II. Methodology for Estimation of Industry-wide Incremental Costs

In order to calculate an estimation of the industry-wide incremental costs of each of the three New Models, ISDA requested submissions of cost estimation from individual member firms that are or anticipate being FCMs to clear swaps for their customers. These estimations were performed in respect of three different possible sets of costs: (a) operational and compliance costs, (b) increases in IMs and (c) increases in guarantee fund contributions. The methodologies used for these three estimations are set out below.

Operational and Compliance Costs Estimation Methodology

After identifying the different sources of additional operational and compliance costs set out under "Operational and Compliance Costs" in section I above, individual FCMs submitted their own estimations of the additional costs for that FCM that would be incurred in complying with the requirements of each New Model. These estimations were split into upfront and ongoing annual incremental costs.

As each FCM was making an estimation of incremental costs over the Baseline Model, each FCM was required to make certain assumptions about future activity, and ISDA recognized that different FCMs may make different assumptions depending on their assessment of the likely activity of their customers. However, in order to maximize the consistency of approach, ISDA proposed guidelines to be used by the FCMs in making their estimations. These guidelines were as follows:

- For one customer there would be a minimum of five accounts per currency in order to move cash and securities of such customer and subsequently the DCO for cleared swaps: (a) regular cash account (account into which customers pay monies at the FCM, a combination of variation margin and IM), (b) FCM settlement account (the FCM's representation of the client account sitting at the particular DCO), (c) investment account (client account at the FCM where excess funds are held for investment), (d) FED custody account (individual client account at the FCM for securities being held as either excess collateral or the pledged collateral for IM at the FED) and (e) DTC custody account (individual client account at the FCM for securities being held as either excess collateral or

the pledged collateral for IM at the DTC). For the Individual Segregation Model, five accounts per currency for each client will be required.

- On average, a customer will have requirements in two currencies.
- On average, a customer will clear through two different DCOs.
- There are 250 business days per year.

Under the Baseline Model there would be one payment made by the FCM to the DCO daily to cover the margin call for all the FCM's customers. In the Individual Segregation Model as it relates to the FCM and DCO relationship, as an example, assuming one FCM, two DCOs, one currency, and 1000 client accounts, a FCM would have to make 2000 wire transfers compared with the two wire transfers it would have to make under the Baseline Model. Under the Individual Segregation Model, it is easy to see how the number of wire transfers, accounts, and other activities would increase exponentially with multiple DCOs and currencies.

In conjunction with the wire transfers, there is the additional duty of reconciling the cash and security balances at each of these accounts for each client at each DCO against the equivalent at the FCM. The current CFTC regime requires regulatory balance reporting by noon EST daily for the existing omnibus accounts. The Individual Segregation Model would require confirmation and reporting of balances across the entire population of customer accounts as described above. The CFTC regulations require supervision of these activities by experienced and senior members of the FCM's organization, which therefore generally requires a senior individual to fulfill this role. Lastly FCM and DCO's infrastructure would need to be retooled in order to create the full segregation capability required by the Individual Segregation Model. The cost estimates set out for the Individual Segregation Model in section III below reflect these considerations.

As mentioned, the FCMs were free to modify these proposed guidelines if they felt that other assumptions were more appropriate and would more accurately reflect their customers' anticipated activity.

ISDA then calculated the average upfront and ongoing annual incremental costs for an individual FCM for each model.

Increases in IMs

The methodology used to estimate the industry-wide increase in IMs for the Individual Segregation Model and the LSOC Model adhered to the following steps: first, data from the interest rate OTC derivatives market was used to identify the current gross notional amount of customer transactions. Second, individual FCMs determined the gross notional of their own customer-facing transactions (the "FCM Customer Gross Notional"), and the gross notional of those transactions that are likely to be cleared, taking into account those customers whose activities are likely to be exempt from clearing (the "FCM Customer Cleared Gross Notional"), expressed as a percentage of the FCM Customer Gross Notional (the "FCM Customer Cleared Percentage"). Next, the required IM using the 99% confidence level was calculated by individual FCMs for the FCM Customer Cleared Gross Notional, expressed as a percentage of the FCM Customer Cleared Gross Notional (the "FCM Customer IM Percentage"). The FCM Customer IM Percentage was then recalculated using the

99.9% confidence level¹, and the increase in the FCM Customer IM Percentage between the 99% and the 99.9% confidence levels was expressed as a percentage increase (the “FCM Customer IM Percentage Increase”). Finally, the FCM Customer Cleared Percentage, FCM Customer IM Percentage at the 99% confidence level and the FCM Customer IM Percentage Increase were reported by the participating FCMs to ISDA.

From the submissions received, ISDA took a simple average of the FCM Customer Cleared Percentages and FCM Customer IM Percentage Increases reported, and applied them to the gross notional reported for all customer interest rate OTC derivatives transactions to produce an estimation of industry-wide increases in IM that would be required for the three New Models.

To estimate the industry-wide increase in IMs for the Waterfall Model, ISDA used the same figures for current gross notional amount of customer interest rate transactions, average FCM Customer Cleared Percentage, and average FCM Customer IM Percentage to determine the current anticipated IM required for interest rate swaps. To avoid overstating the increase in the IM required, and reflecting the uncertainty around how DCOs will assess the risk of delay in accessing customer collateral as a default resource, the increase in IM for the Waterfall Model was estimated at 45%.

Further details and observations on this process are set forth below.

ISDA believes that in order to estimate increases in IMs that would result from any of the three New Models, it is necessary first to estimate the likely gross notional amount of customer cleared transactions, because the IMs posted by clearing members for their house positions will continue to be a DCO default resource under any of the three New Models, as is currently the case for the Baseline Model. As a proxy for this trade population, ISDA used data from the Interest Rate Trade Repository Report published by TriOptima as of close of business on November 19, 2010², specifically the USD equivalent of the gross notional amount of interest rate OTC derivatives transactions with Non-G14 Dealer counterparties reported to TriOptima³. To ensure consistency, FCMs were asked to determine their individual FCM Customer Gross Notional figures using data reported to them by TriOptima as of the same date. The TriOptima figures for transactions with Non-G14 Dealer counterparties are considered to be a reasonable proxy for industry-wide interest rate OTC derivatives transactions with customers, given the level of participation in TriOptima’s Interest Rate Trade Repository Reports and the firms included in the G14 Dealers. The data used was limited to the interest rate asset class because the gross notional amount of interest rate OTC derivatives is by far the largest component of gross notional amount in the OTC derivatives market⁴, and because including other asset classes would introduce further complexity that likely could not properly be taken into account in the time available. ISDA stresses that because this excludes other asset classes, it will likely have resulted in an understatement of each FCM Customer IM Percentage and FCM Customer IM Percentage Increase and will therefore produce an understated estimate of industry-wide IM increase required.

¹ The ANPR makes reference to “99.99%”, but ISDA believes the number actually referred to was “99.9%”.

² Available at <http://www.trioptima.com/repository.html>

³ The total gross notional figure transactions with Non-G14 Dealer counterparties was USD 163,315 BN.

⁴ According to the Bank for International Settlements (“BIS”), at the end of 2009 the total notional amount of all derivatives outstanding was USD 614,674 BN, while the total notional of interest rate derivatives was USD 449,793 BN, or 73%.

The actual IM that is required to be posted by a clearing customer to a DCO will depend on the portfolio of derivatives that customer has facing that DCO, which of course varies by customer. In calculating the FCM Customer IM Percentage, FCMs were therefore asked to calculate, for transactions that are likely to be cleared, the current IM requirements for each customer individually at the 99% confidence level, and to aggregate those to produce the FCM Customer IM Percentage. Importantly, this calculation reflects an embedded assumption that each customer will clear through only one DCO, which maximizes the benefits of portfolio margining and therefore, as with the exclusion of other asset classes, potentially understates the FCM Customer IM Percentages and FCM Customer IM Percentage Increases.

In practice, not all interest rate swap transactions will be cleared, either because the underlying product is not cleared by any DCO, or because clearing of the particular interest rate product is not mandatory and not cleared or because the customer is relying on an exemption from the clearing requirement. That is why FCMs were asked to estimate the FCM Customer Cleared Percentage, to avoid potential overstatement of the FCM Customer IM Percentages and FCM Customer IM Percentage Increases.

For the Individual Segregation Model and the LSOC Model, following suggestions made at the Commission's Staff Roundtable on Individual Customer Collateral Protection (the "Roundtable") and reported in the ANPR, DCOs will require IMs to be calculated at the 99.9% confidence level, instead of the 99% level, if the collateral of non-defaulting customers is not available as a DCO default resource. ISDA's estimates use the same methodology, which is why each FCM Customer IM Percentage Increase was calculated as the change resulting from moving from the 99% confidence level to the 99.9% confidence level⁵.

For the Waterfall Model, substantial further study would be required to develop a margin methodology that recognized that some risk factors could be managed within a five day period and others, within ten days, and then to determine from a representative sample of client portfolios what the average or industry-wide effect would be given those factors. If the period of risk to be covered by IM were increased from five to ten days, then the required increase in IM was preliminarily estimated at 75% based on the interest rates asset class. However, to reflect the questions raised over whether such risks could be hedged during the default procedure period in respect of the guarantee fund, this was reduced to 45%. More precise estimates could be generated with further study, as recommended herein.

Increases in Guarantee Fund Contributions

The methodology used to estimate the industry-wide increase in guarantee fund contributions for the Individual Segregation Model and the LSOC Model was as follows: a ratio of total IM to total gross notional for OTC interest rate derivatives transactions was calculated by two FCMs by deriving a theoretical IM for each counterparty of that FCM (excluding cleared transactions and intra-group transactions, but not limited just to customer counterparties) at the 99% confidence level, assuming that all such transactions are cleared with the same DCO.

⁵ As noted above, the ANPR reports that a DCO estimated at the Roundtable that "it might need to increase collateral from a 99% confidence level to a 99.99% confidence level", but ISDA believes the increase described was in fact to a 99.9% confidence level. An increase to the 99.99% confidence level would imply a 200% increase in collateral required.

The percentage of transactions in the interest rates asset class that will be cleared was then estimated. In contrast with the FCM Customer Cleared Percentages estimated for the IM increases explained above, this estimate was based on all transactions, not just transactions with customers, since any increases to the required guarantee fund of a DCO will apply to FCM “house” as well as FCM customer positions.

The ratio of IM to total gross notional and the percentage of transactions that will be cleared were then applied to the outstanding gross notional amounts for the interest rate asset class obtained from the BIS report as of December 2009⁶ to estimate the industry-wide IM requirements for that asset class.

The IM requirement calculated for the interest rates asset class was then used to determine the guarantee fund that ISDA believes will be required by DCOs as a percentage of the total IM based on current market practice for clearing interest rate swaps. For this purpose, it was assumed that the largest two clearing members will account for 12.5% of the cleared notional each (25% together), and that the IM required at the 99.9% confidence level is 60% more than that required at the 99% confidence level. In futures, at the CME, ISDA understands that the two largest FCMs currently account for approximately 30% of the IM together, so the 25% assumption here is conservative. The 60% increase was estimated by fitting a fat-tailed distribution to interest rate OTC derivatives transactions.⁷ Based on information provided by DCOs, the guarantee fund would be required to approximately double⁸ if the collateral of a non-defaulting customer is not available as a DCO default resource, i.e. under the Individual Segregation Model and the LSOC Model. ISDA used this to estimate the increase in guarantee fund requirements that would be required.

ISDA did not estimate an increase in required guarantee fund contributions for the Waterfall Model, because the calculation would require more understanding of the make-up of OTC Cleared client omnibus accounts in terms of size distribution and diversity of client risk at the typical OTC clearing FCM.

III. Cost Estimate Results

The incremental additional costs on an industry-wide level for each of the three New Models over the Baseline Model obtained using the methodologies described above are presented below, followed by some observations on the results. For each New Model, the additional upfront and annual operational and compliance costs are presented, followed by the additional IM requirements and the additional guarantee fund requirements. ISDA does not express a view as to what might be an optimal balance between IM and guarantee fund requirements for each New Model, and so, with the exception of the Waterfall Model, the incremental IM requirement and the incremental guarantee fund requirements are presented as alternates. The incremental cost of a particular New Model over the Baseline Model is therefore the upfront and ongoing additional operational and compliance costs of that New Model plus either the additional IM requirement or the additional guarantee fund contribution requirement for that New Model.

⁶ BIS, OTC derivatives market activity in the second half of 2009, available at www.bis.org.

⁷ As a comparison, for futures, which are much more normally distributed (once the stochastic volatility component is removed by de-volatizing) the corresponding number is 33%.

⁸ See for example comments made by Ms. Taylor at the Commission’s Staff Roundtable on Individual Customer Collateral Protection at page 124 of the transcript:

http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_102210-transcrip.pdf

The results are summarized in the table below as additional costs over the Baseline Model:

	Individual Segregation Model	LSOC Model	Waterfall Model
Average upfront operational and compliance cost per FCM: ⁹	\$33.2 million	\$1.0 million	\$0.8 million
Average ongoing annual operational and compliance cost per FCM: ¹⁰	\$136.3 million	\$16.2 million	\$16.1 million
Industry-wide additional IM required: ¹¹	\$581 billion	\$581 billion	\$375 billion
Industry-wide additional guarantee fund contributions required: ¹²	\$128 billion	\$128 billion	N/A ¹³

Observations on Results

As noted above, the FCMs were required to make a number of assumptions about future activity, and given the time available for comment on the ANPR, it was not possible to develop stricter assumptions that could be applied across FCMs. In addition, the manner in which the cost information requested is accounted for in different FCMs may vary widely, presenting challenges in arriving at a consistent set of assumptions and categories for the various costs involved. These estimates could be substantially improved by a more detailed study of these issues than was possible in the time allowed for this letter. Thus, given the high potential costs shown in these estimates, ISDA strongly encourages the Commission to undertake a full and thorough study with input from a broad set of market participants to develop the most accurate assessment possible of the costs to the industry of implementing any of the three New Models and to delay issuance of proposed or final rules until such a study can be completed.¹⁴ Increased expense may make a

⁹ ISDA received submissions on upfront costs from 5 FCMs.

¹⁰ ISDA received submissions on ongoing annual costs from 6 FCMs.

¹¹ ISDA received submissions from 4 FCMs.

¹² It is important to note that the guarantee fund increase figure reported here reflects only the funded portion of the guarantee fund. It is likely that clearing members' liability to contribute to the unfunded portion of a DCO's guarantee fund would also be increased.

¹³ A figure for guarantee fund contribution increase has not been included for the Waterfall Model, as the calculation would require more understanding of the make-up of OTC Cleared client omnibus accounts in terms of size distribution and diversity of client risk at the typical OTC clearing FCM.

¹⁴ Potential assumptions about future states that would need to be made to estimate costs more accurately would include: balance sheet treatment of unmatured cleared and non cleared trades to each counterparty in the chain of trading; determination of counterparty population (if any) that will be exempt from mandatory clearing; behavior of end users in light of clearing fees and cost / benefit amongst available investment options; number of FCMs, size of those FCMs, and market share of each; determination of population of which cleared and uncleared trades and at what time (assuming a phased evolution toward clearing); the individual risk methodology of each DCO as well as rules which define membership criteria; number of CCPs centrally clearing in any given market; risk management factors in FCM and

number of investment strategies unworkable, reducing liquidity and further driving up costs for all market participants.

The ongoing annual operational and compliance costs for the Individual Segregation Model are significantly higher than for the other two New Models. This is driven in part by the volume of accounts that would need to be maintained for each customer, and the large number of customers. In particular, it should be noted that as the value of each customer's cleared swaps portfolio will likely change each day, a payment of variation margin will need to be made for each customer each day for each currency and for each DCO with which that customer clears. This stands in stark contrast to the position under the Baseline Model, the LSOC Model and the Waterfall Model, in which each FCM need make only one payment each day per currency to each DCO, representing the net variation margin required to be paid by that FCM across all of its customer cleared swap portfolios. Similarly, where IM is in the form of securities, a separate securities settlement will need to take place for each customer each time that customer's IM requirement changes, whereas under the other models, only the net change in IM across all the FCM's customers with the relevant CCP need be transferred. In addition, under the Individual Segregation Model, the actual security provided as IM by the customer will need to be transferred to the DCO, further reducing the netting benefit that can be obtained under the Baseline Model by converting IM provided by the customer into other eligible investments. The result of this very large increase in the number of payments and securities settlements is a very large increase in annual wire and securities settlement fees. If the FCM is required to post specific securities provided by its client, it would also need to consider the impact of substituting the client's securities for any pre-funded amounts provided by the FCM, i.e. the FCM would need initially to post collateral on behalf of the customer, then subsequently post the specific securities provided by the customer and receive back the pre-funded amount.

Although the ANPR is not explicit on this point, ISDA interprets the Individual Segregation Model as described in the ANPR to require that, if requested by the customer, the specific assets posted by a customer as collateral must be transferred to the DCO or a depository, provided that the assets posted by the customer are eligible to be posted as collateral to the DCO, i.e. those assets cannot be converted into other investments permitted by Commission Regulation 1.25. This interpretation is reflected in the estimates set out above. ISDA has based this interpretation on a negative inference, as in its description of the Individual Segregation Model, the ANPR does not state that customers bear the risk of loss on the value of collateral subject to the investment restrictions of Commission Regulation 1.25 (unlike the descriptions of the LSOC Model, the Waterfall Model and the Baseline Model). ISDA welcomes additional clarification from the Commission on this issue.

It should be further noted that the estimates above only reflect the costs at the FCM level. To the extent that multiple accounts must be maintained by FCMs to segregate individual customers' collateral, the same number of accounts would need to be reflected at the DCO level. These estimates also do not take account of costs that DCOs would incur as a result of the increased number of accounts to be maintained.

For each of the three New Models, there is an increase in operational and compliance costs compared to the Baseline Model. In addition to the costs noted above for the Individual

concentration and quality of clients at the FCM; the DCO's allocation between guarantee fund contributions and IM required; the allocation between the funded and unfunded portions of the guarantee fund at each DCO; and natural market evolution of where (asset class, tenor, global jurisdiction) investment managers determine the opportunities lie (i.e. portfolio construction).

Segregation Model, the increased costs under all three New Models are driven by the need to provide for additional staffing to comply with the information monitoring and reporting requirements that the three New Models imply. As noted above, the ANPR did not explicitly set out the operational and compliance obligations under the Waterfall Model. ISDA believes the small discrepancy between the numbers reported above between the LSOC Model and the Waterfall Model may represent different interpretations of that requirement. ISDA believes that if no additional reporting activities are required under the Waterfall Model compared with the Baseline Model, that there would not in fact be a significant increase in operational and compliance cost compared with the Baseline Model.

The additional IM and guarantee fund contributions required by the Individual Segregation Model and the LSOC Model are the same. This is because, as noted above, the risk impact of these two New Models on the DCO is the same. The additional IM required by the Waterfall Model would be roughly similar.

The interest rates asset class, while a very high percentage of derivatives, does not encompass all asset classes that likely will be cleared. The estimates of IM increase over the Baseline Model, reflecting only interest rate data, are therefore lower than they would have been had time and data been available to expand the analysis to other asset classes.

The results of the estimations used to calculate the additional IM required by each of the three New Models are set out below:

Additional IM required (compared with the Baseline Model):

	Individual Segregation and LSOC Models	Waterfall Model
Gross notional amount of transactions with Non-G14 Dealer counterparties:	\$163,315 billion	\$163,315 billion
Average of FCM Customer IM Percentages at 99% confidence level:	0.63%	0.63%
Average of FCM Customer Cleared Percentages:	81.00%	81.00%
Estimated industry-wide total IM required for customer cleared transactions at 99% confidence level:	\$833 billion	\$833 billion
Percentage increase in IM ¹⁵ :	69.75%	45.00%
Estimated industry-wide total increase in IM for customer cleared transactions:	\$581 billion	\$375 billion

¹⁵ Please see Section II above under “Increases in IMs” for details on how these percentages were estimated.

The estimates used to determine the additional guarantee fund contributions required (compared with the Baseline Model) for the Individual Segregation Model and the LSOC Model based on the interest rates asset class are as follows:

Gross notional amount of transactions (all counterparties):	\$449,793 billion
Clearable percentage:	90%
Ratio of IM to gross notional:	0.21%
IM requirement:	\$850 billion
Guarantee fund contribution as percentage of IM:	15%
Guarantee fund contribution:	\$128 billion

IV. Optional Models

As will be clear from the above, each New Model implies significant additional cost over the Baseline Model. The ANPR suggests the possibility of customers being offered a choice between different models.

If optionality is offered, certain costs could be incurred by FCMs and DCOs in providing any New Model. To give market participants appropriate incentives, the implementation of any requirement on FCMs or DCOs to offer optionality should be carefully considered so that those customers who do not select the option of increased collateral protection do not directly or indirectly bear the cost of offering that protection to other customers. One way in which this might occur is if highly credit worthy customers choose the more expensive, higher protection, option, so that the fellow customer risk is borne by the more risky customers, thereby reducing the effectiveness of the pooling from the point of view of the DCO, who must now also raise IM for those bearing fellow customer risk. This increase in IM not only results in an increased funding cost for those clients that did not need or want increased protection, but also increases the amount of collateral that those customers have at risk of loss mutualization.

* * *

ISDA appreciates the opportunity to provide comments on the Proposed Regulation and looks forward to working with the Commission as you continue the rulemaking process. Please feel free to contact me or my staff at your convenience.

Sincerely,



Robert Pickel
Executive Vice Chairman